PART 10

MONTANA TAX STUDY

MONTANA. TAX STUDY TASK FORCE

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AN INTEGRATED TAX STRUCTURE FOR MONTANA

by

The 1966 Montana Taxation Task Force

William D. Diehl, Ph.D.
Howard H. Lord
Maurice C. Taylor
Layton S. Thompson, Ph.D.
Robert F. Wallace, Ph.D.
Robert W. Worcester
John H. Wicks, Ph.D.

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CHAPTER 10

AN INTEGRATED TAX STRUCTURE FOR MONTANA

How tax burdens should be apportioned among individuals is the central question in tax policy. Tax reform implies that the tax system be modified so that the new system is somehow better than the old system. The presumption in any alteration of the tax system is that somehow the existing or actual tax structure is different from the ideal structure in respect to burden distribution, economic effects, and administration problems. It is the purpose of this chapter to describe an ideal tax structure according to these three aspects, to compare this ideal with the existing or actual tax structure, and to suggest the necessary positive steps to eliminate the discrepancy.

An Ideal Tax Structure--Its Elements

An ideal tax structure from the point of view of equity is difficult to establish. However, we can establish some reasons for reliance on equity concepts in the allocation of tax burden.

The benefit basis of taxation, although not useful as a rigid concept in allocating tax burden, is sometimes useful to define certain groups of taxpayers. It is not always feasible to collect taxes from only those who benefit directly from government expenditures. It makes little sense to require those on welfare to pay taxes to support themselves. On the other hand, some groups derive special benefits from certain kinds of government expenditures when these groups are not regarded as the proper objects of subsidy. In such cases, when special levies are possible and feasible, they may be appropriately used. The taxes on motor fuels are an example. Hence, we may rely partially on the benefit concept to allocate the tax burden in an ideal structure.

The ability-to-pay criteria for allocating the tax burden is useful to define groups of taxpayers based on their economic circumstances. We agree that ability-to-pay is positively related to the level of income, but we have no scientific criteria for suggesting ways to determine the most appropriate rates of taxation on different levels of income. We know that a destitute person can pay no taxes. We also know that in most instances a person with income and property can pay taxes. But the equity of specific gradations of tax burden over different income classes cannot be justified by scientific methods. Even though we lack scientific justification, the concept is nevertheless valid and we will partially rely on ability-to-pay for allocating tax burden in an ideal tax structure.

An ideal tax structure from the point of view of economic effects would be one that left the allocation of resources and the distribution of goods as they would have been in the absence of the tax system. This

implies for an ideal structure that taxation does not distort (1) the relative prices of goods and services consumed in Montana and (2) the relative prices of resources used in production in Montana. It also implies that taxation does not alter Montana's competitive position relative to other states by disrupting the patterns or development of commerce. These criteria provide some basis for suggesting positive steps to eliminate the discrepancies between the existing or actual tax structure and the ideal tax structure from an economic point of view.

There are numerous discrepancies between the actual and ideal tax structures from the point of view of administration and compliance costs and problems. In many cases our taxes are inconvenient as to time and manner of levy. Some taxes are costly to collect both from administrative and compliance points of view. Some taxes are uncertain and arbitrary. We have concluded that convenience, economy and certainty can be achieved best through simplicity. Simplicity, though in some cases difficult to achieve, is therefore a major aspect of an ideal tax structure.

In general it is the opinion of the Taxation Task Force that the entire system of taxation in Montana be made more certain and simplified, and that there should be a definite statement of goals to emphasize and retain these elements over time. Complicated tax laws and procedures make it difficult for the average citizen (1) to understand existing tax policy, (2) to evaluate changes in rates and other provisions, and (3) to comply with the laws. Also, complicated tax laws make it difficult for taxpayers to express their views regarding equity considerations through the political process.

A simple tax structure requires less in collection and administrative costs, and therefore will release funds for public and private use.

Problems of convenience, economy and certainty of taxation may all be substantially reduced by establishing a simplified tax system. Simplicity of the tax structure, in other words, is an intermediate goal of an ideal tax structure by which we may achieve the more important elements of convenience, economy and certainty.

In summary, the ideal tax structure will be based on the following criteria:

1. Equity.

    a. Benefits received serve as a basis for allocating tax burden in cases where benefits can be measured and subsidization of the beneficiaries can not be justified.

b. Ability-to-pay plays a role in allocating tax burden in relation to income.

2. Economic effects.

a. Taxes should do the least to distort price relationships in the production and consumption sectors of Montana's economy.

b. Suggestions for changes in taxes should improve Montana's competitive position relative to other states.

c. Changes suggested would minimize difficulties in establishing and carrying on commerce in Montana; they will promote rather than retard economic growth.

3. Administration and compliance costs and problems.

a. Suggestions will stress the certainty of taxation; taxes should be intelligible to the taxpayer. In order to achieve this goal, simplicity will be stressed.

b. Suggestions for altering and structuring taxes will seek more equitable administration of taxes in Montana. Not only is it necessary to treat people in like circumstances alike, but it is also necessary to know how the taxation of people in different positions differs.

c. Efficient administration of Montana taxes is sought through changes that recognize the impossibility of administering some taxes and the high administrative costs of collecting others.

Property Taxation

The Task Force recommends as a long-run goal that all statewide property tax levies be eliminated. In the short-run, because of the dependence of bonding on the property base, we must retain levies for bond interest and redemption until 1973. For the long-run we should develop other means of financing state bonds.

It is recommended that the University millage and the General Fund millage be eliminated. Elimination of the University millage would result in an annual revenue loss of about $4.5 million. The two-mill General Fund

levy raises about $1.5 million. The three levies for bond interest and sinking raise between $0.5 and $1.0 million per year depending on the levies. Our proposal to eliminate all statewide property levies but retain livestock levies and bonding levies would result in a revenue loss of roughly $ 6.0 million. A period of three to five years should be allowed for gradual elimination of these levies.

In the study of the assessment of (1) agricultural products held for sale, (2) solvent credits, (3) merchants and manufacturers inventories, and (4) household effects, it was concluded that these four types of property are not now assessed with an acceptable degree of equity, and that they should be eliminated from the tax roles. The economic effect of the property tax on merchants and manufacturers inventories appear to be adverse. We recommend that those four classes of properties not be taxed.[1]

Elimination of taxes on agricultural products held for sale, solvent credits, merchants and manufacturers inventories and household effects would not result in a loss to the state if statewide levies were eliminated. If statewide levies were eliminated, the revenue loss to the state from these four sources would be about $0.5 million. It is estimated that the property base loss to all counties by eliminating the four classes of property would be about $50 million. Loss of tax base in a county would not necessarily result in a loss of revenue but could be replaced by an increase in levies on remaining property. The average (of all counties) mill levy increases needed to offset reductions in taxable values would be about 1.79 mills for household goods, 0.38 mills for solvent credits, 0.28 mills for agricultural products, and 2.78 mills for merchants and manufacturers inventories--or a total of 5.23 mills for all four categories.

Even though our recommendations suggest that the state become less involved in property levies, we recommend that the state play a larger role in helping to achieve equity in assessments, both within and between counties, for two reasons: (1) distribution of state aid to schools is based on assessments, and (2) inter-county property is assessed uniformly and allocated to counties wherein the mill levies are applied. It is further recommended that all the state revenue eliminated by discontinuing statewide levies be replaced by appropriable General Fund revenue.

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[1] See Howard H. Lord, "Montana Property Tax Assessment Problems" Appendix 1 to Part VI, p. 51.

<u>Individual Income Taxes</u>

The Task Force recommends that any additional or replacement taxes be collected through an income tax. This recommendation arises because: (1) an income tax can be constructed to accomplish <u>any</u> goal that may arise in state fiscal policy; (2) we already have the administrative machinery to fulfill the necessary administrative functions with little or no added cost, and (3) its revenue potential is at least as high as any other single source. This recommendation is in keeping with the objectives of simplicity, convenience, economy and certainty of taxation.

Our present income tax should be made simpler and more certain by eliminating personal deductions and exemptions. The effect of this simplification, among other things, would make the taxes paid by individuals with similar income more uniform than is presently the case.

Elimination of all personal deductions (interest, contributions, Federal income taxes, etc.) would increase income tax revenue by about $16.2 million. Since the Federal government allows the deduction of the state income tax, a share of the increase in state income tax revenue of $16.2 million will be passed on to the Federal government in the form of lower Federal taxes. The Federal income tax deductions would increase $16.2 million, and the Federal income tax paid by Montana individuals would be reduced by an estimated $3.2 million. Elimination of all deductions will make the Montana income tax more progressive; but since the state income tax is deductible from the Federal income tax, the increased progressivity of the state income tax will be partially offset.

If a dependent <u>exemption</u> provision is desired, we recommend that a $6.60 tax credit be allowed for each dependent. Thus, instead of excluding $600 from taxable income for each dependent, $6.60 would be subtracted from the state income tax liability. In this case, a dependent results in the same tax saving for all families regardless of the level of their incomes. This change would result in $10.5 million additional revenue. Here again, a share of this higher state tax bill can be passed on to the Federal government in the form of less Federal taxes paid by Montanans. The amount Federal income taxes might be reduced is estimated at $2.1 million.

With 1965-67 tax rates, with no deductions and a $6.60 tax credit in lieu of each $600 dependent exemption, our income tax would yield $26.7 million more revenue than with the existing deductions and exemptions.

A one percentage point increase in the rates in each of the six income brackets (the rates would be from 2.1 to 8.9 percent) would yield about $6.4 million if other provisions remained the same as they are now.

However, if all the suggested changes were made (that is, if we eliminate deductions and allow a $6.60 tax credit in lieu of each dependent exemption of $600), we might expect about $14.4 million in additional revenue from increasing existing rates one percentage point in each bracket.

Another important problem from the standpoint of both equity and administration problems is that of separate filing of Montana tax returns by married taxpayers. Currently, if a wife earns income, she may file a return separate from her husband. There is a major problem in auditing these returns. The two returns must be together to properly audit them and this is difficult to accomplish. Taxpayers are never sure how to allocate income, deductions and exemptions between returns. Also, there are a large number of taxpayers, especially in low income groups, who unknowingly do not take advantage of filing separate returns.

There are two main alternatives for solution to these problems: (1) make some provision for income splitting, or (2) eliminate the provision allowing separate filing in our income tax law. The Task Force recommends that the provision for separate filing be eliminated. The additional revenue forthcoming from this change would be about $3 to $5 million per year.

These proposed changes in the income tax are concerned with the base of the income tax and not the rates which should apply in each income bracket. The Task Force feels the appropriate rate structure is a legislative policy decision. The individual taxpayer burden by income bracket with alternative rate structures and provisions of the income tax, in addition to the revenue yields of the various alternative rates and provisions, will be made available subsequently.

The total additional annual revenue gain to the state from these income tax changes would be as follows:

1. Elimination of all deductions----------$16.2 million
2. The $6.60 tax credit in lieu of the $600 dependent exemption----------- 10.5 million
3. Elimination of the separate filing provisions---------------------------- 3.0 to 5.0 million

Total----------------$29.7 - $31.7 million

The total state annual revenue loss due to suggested changes in the property tax would be as follows:

1. Elimination of the University millage--$4.5 million
2. Elimination of the 2-mill General Fund Levy------------------------------ 1.5 million

Total -----------------------$6.0 million

The net revenue gain from all proposed changes is from $23.7 to $25.7 million.

Individual Proprietorships and Corporate License Taxes

There should be more resources devoted to the audit of business tax returns. Our study of these returns indicates that considerable improvements in reporting of business expense and incomes can be made by simply having additional qualified personnel to audit returns not only for errors but for substance. The state of Montana should provide its own tax forms with explicit instructions regarding their use.

Inheritance Taxation

The Task Force has no recommendations for changes in the inheritance tax law at this time. However, we feel that provisions for exemptions and deductions and the overall concept of the tax should be given considerable attention in the near future. Further study should be made of the administrative problems of the inheritance tax as well as its equity implications.

Regulatory Taxation

There are a number of taxes which may be regarded as nuisance taxes from the point of view of carrying on commerce. They were originally levied to regulate certain aspects of business as well as to gain revenue. Some of these taxes on licenses, permits and certificates are not appropriate means of control but are necessary to gain constitutional authority for control. They are inconvenient as to time and manner of levy, they are uncertain and they provide little revenue. It is our opinion that taxes of this nature are stifling to establishing and carrying on commerce, and therefore the legal and constitutional framework should be changed to permit their elimination.